DOW THEORY LETTERS INC.

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36 Letters per Year – $75 Annually

Registered with the Securities Exchange Commission

May 13, 1970 Letter 461

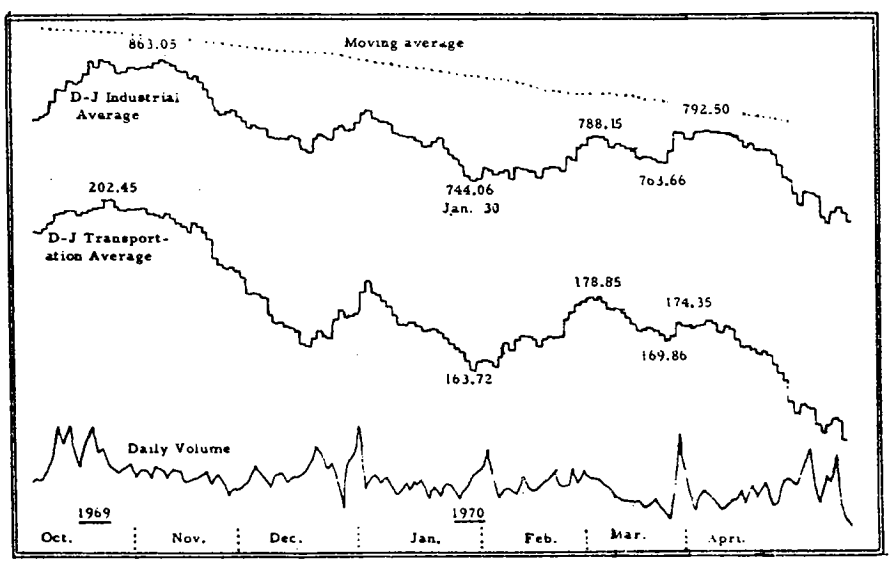
THE MARKET: As if Wall Street was not beset with enough troubles, the Cambodian venture has raised the spector of further demoralization in the bond markets and further additions to the Government's insatiable need for money. The military has termed the Cambodian foray "Operation Total Victory" but I note that my Gotham friend Eliot Janeway has termed it (with financial correctness) "Operation Frying Pan." In my opinion, the Cambodian move is unlikely to produce any great military success, but it has already produced a further copious quantity of mistrust, consternation and misgivings in Congress and throughout much of the country.

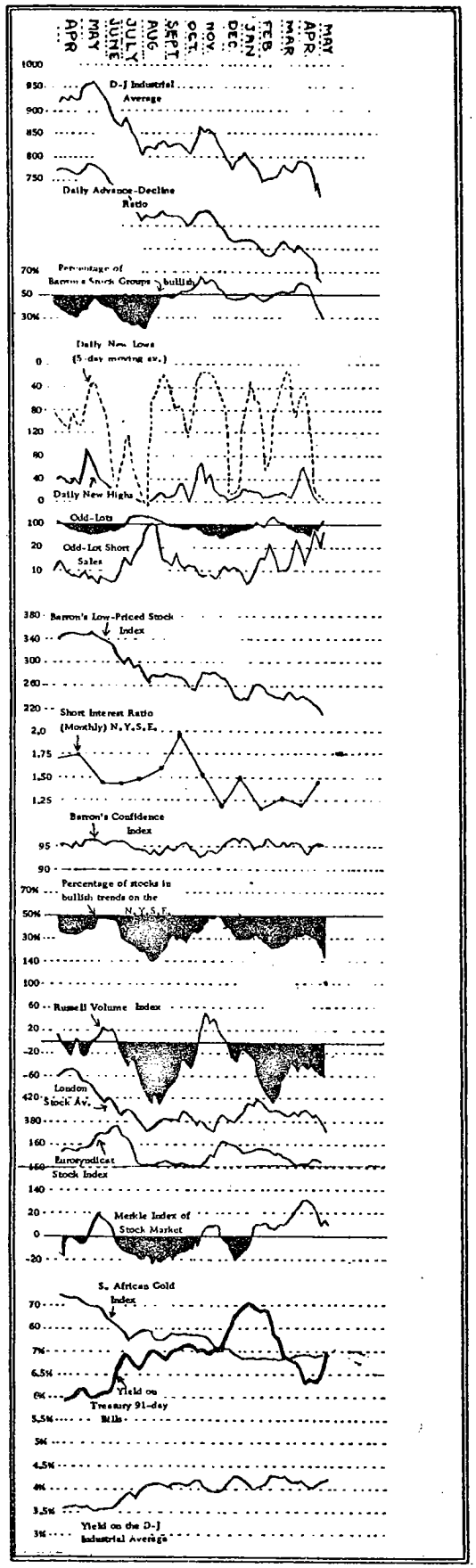
I have no very clear insight into President Nixon's thought processes, but I'm sure of one thing, the President does not read Dow Theory Letters (or if he does, he doesn't take me seriously). I base this on Mr. Nixon's remark of a few weeks ago before a group of visiting businessmen, "Frankly, if I had any money I'd be buying stocks right now."

If the President is not worried, neither, it seems, are our leading corporations. For despite the face that factory lay-offs are now the highest in six years, despite a collapsing stock market, despite a crunch on corporate profits and record interest rates, the latest McGraw-Hill survey shows that business plans to spend $82.3 billion (9% over 1969) on new plants and equipment (I ask myself if this is possible)!

Confidence seems now to be literally "built in" to Wall Street and Main Street, and even in that most sophisticated sector of the financial community, the bond market, confidence is amazingly high. This can be seen in the fact that Barron's Confidence Index has been in the 90's for the past few years, and this indicates that the ratio of the yields on the highest grade bond average to the broad 40-Bond Average is very high. In other words, investors are paying literally no premium to purchase a top-rated bond vs. a medium-rated bond. I believe that this fantastic confidence is misplaced, but of course that's just my opinion. The fact is that misplaced or not, the confidence is there.

Another fact is that this bear market has now wiped out approximately $200 billion in equity values. That massive erosion in values is going to be felt six months to





a year from now. People are waking to find that they are poorer, that they can no longer spend money like water, and that "something different is taking place." Restaurants are feeling the pinch, stores are feeling the pinch, corporations are feeling the pinch, and my bet is that by this time in 1971 the whole nation will be very much aware of the difference that $200 billion in lost values exerts.

I want to emphasize again that aside from the actual price movements, a major primary bear market is subject to three psychological phases. We are now in the second phase of the bear market, and this is the phase in which stocks collapse in response to actual developments on the social, political and economic front. Many people over the past few months were shocked to see highly-touted stocks of all varieties cave in, sometimes as much as 10% to 25% in a single session. Others are amazed at the pile-up of "bad news" which seems to pop up from every possible direction, the monetary front, Washington, business, labor, Vietnam, the campuses, overseas, and dozens of other sources. This is all action typical of the second phase of a bear market. In fact, a characteristic of the second phase is the unexpected, the shocks, the "things that were never supposed to happen."

Yet through it all I sense a persistent optimism, that refusal to believe that the great tide of prosperity and well-being is relentlessly running out. I am reminded of the second phase of the great 1949-66 bull market, the period of 1953 to 1957. There the situation was exactly the reverse. Wall Street and the public were at mid-point in the greatest bull market in history, and prices on an annual basis were moving up to record highs after each successive "crisis". Yet no one could really believe that things were indeed getting better. Any shock such as the Eisenhower heart attack or the Russian "Sputnik" served to throw the market into a panic. Despite the gradually improving atmosphere, despite the steady climb in stock prices, nothing could really turn the public outright bullish regarding Wall Street or the future.

It was not until 1959 and thereafter, as the third phase came into being, that the public began to "feel good." The good feelings increased steadily until the mid-1960's at which time outright euphoria and mindless optimism took over the nation.

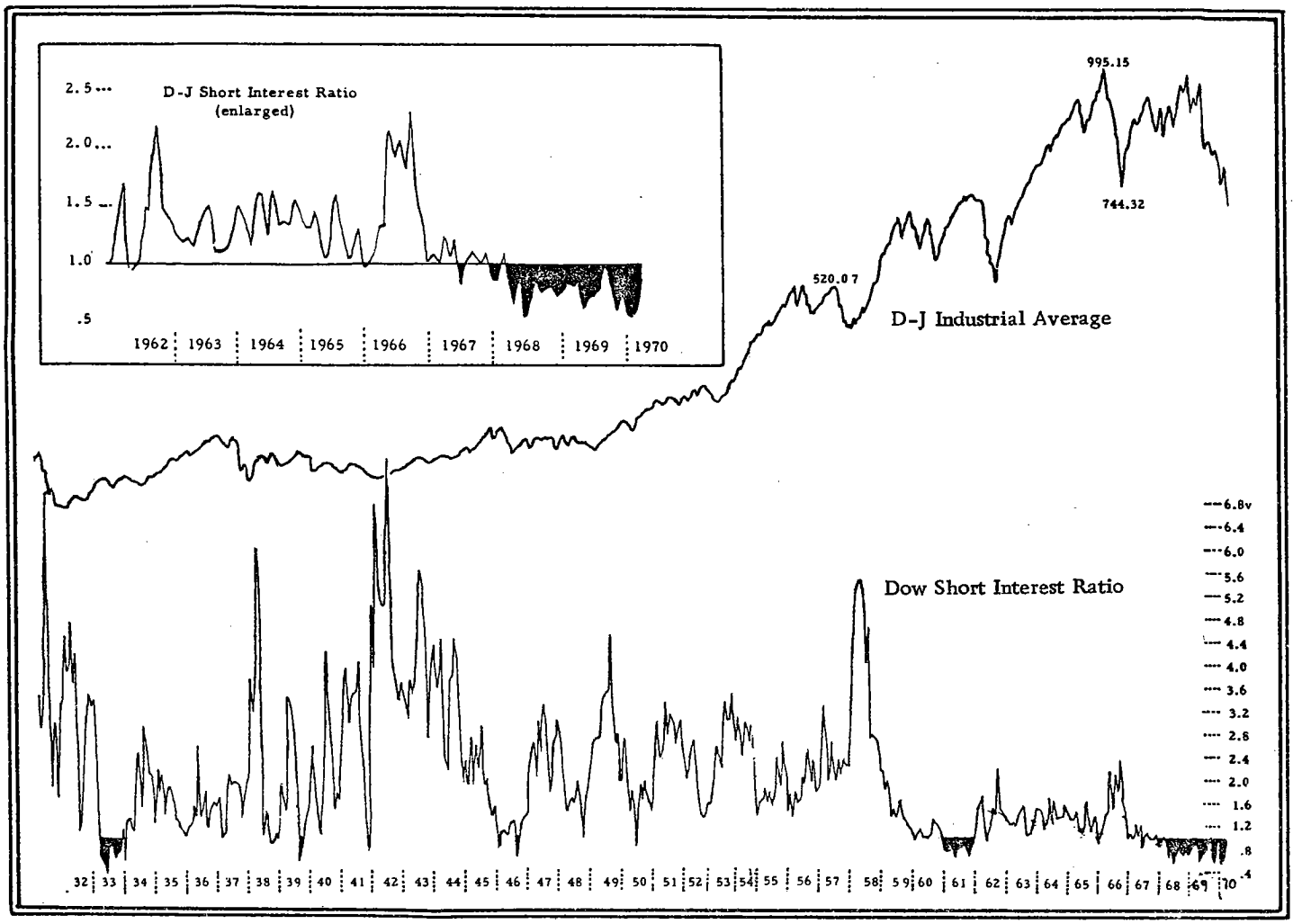
Think about it. At the current Dow lows, almost all of the gains of the 1960's have been wiped out. An entire decade of upside progress on Wall Street had been erased. Yet today, sentiment is still very much on the optimistic side. Ask a friend to forecast a price for the Dow two years from now, and invariably he will be talking in terms of "1000 again" rather than 300 or 400. The fact is that no one really believes that "the Government will allow the economy and the stock market to go down the tubes." Every time President Nixon smiles, every time the Fed makes a move, the market rallies. Faith in the Government is still well nigh unshakable. The volume on the N.Y.S.E. during the whole decline of the past 17 months never once approached a level which suggested that people were in a hurry to get out. On the contrary, the best volume continues to come in on rallying days when the feeling is, "Well, the bearish news is probably all out of the way now, and we have seen the bottom. Things really aren't so bad, and I better do some buying or I'll miss the show."

This is not the kind of sentiment which characterizes the end of a great bear market. On the contrary, it is the kind of sentiment which characterizes temporary bottoms all the way down during the second phase of a bear market. I believe that the vast reservoir of bullish sentiment during this second phase will finally be stamped out when the market crashes and when panic takes over. This could happen in a month or a year, but it seems increasingly obvious to me that only a crash of historic proportions will serve to turn Wall Street stone bearish.

The third and final phase of a bear market deals in hopelessness and forced liquidation. Here decisions are not made on the basis of values, earnings or prospects. They are made on the basis of dire need for cash and liquidity versus bankruptcy. During the third phase the blue chips usually sink to "ridiculous" levels for no other reason than that there is still a market for them, whereas the market for unlisted and lesser quality equities has all but disappeared.

The problem for a Dow Theory analyst during a major bull or bear market is keeping his readers on the main track. I would say that 75% of the public is concerned mainly with the daily action of the market, another 20% (including many sophisticated traders) is concerned with the intermediate trend, and only 5% is concerned with the great primary trend of the market. But it is the primary trend which makes and breaks fortunes, and I always attempt to reverse those percentages. That means that I put 75% of my attention on the primary trend, 20% on the intermediate trend and perhaps 5% on the daily trend of the market. I am trying to educate my readers to adopt the same policy, and to a large extent I feel I have been successful.

NOTE: Last week's lowering of margin requirements from 80% to 65% will accomplish nothing except to indicate that the Federal Reserve Board is panicking as the Dow moves closer to 700. To my mind, the margin move is comparable to giving a loan to a man who is running a tottering business. His problems are profit margins and a product which can't compete in the markets, and a loan in no way changes the fundamentals. Those who buy here on 65% margin will only get "in trouble" quicker during the next major decline. "Leading the horse to more water," isn't going to make a winner out of him at this point. The horse is sick, and it's going to take time, lots of time, before he recovers.



DOW SHORT INTEREST RATIO: This is the indicator developed by Bill Gordon of New York. Bill is kind enough to send me the latest computation each month (tabulations are based on the short interest in the 30 Dow Industrials and the average monthly volume in those 30 stocks). The record of the Dow short interest (DSI) is far superior to the standard and widely followed N.Y.S.E. short interest ratio. Dow Theory Letters is the only service which publishes a chart of the DSI on a regular basis (or any basis at all, for that matter).

I like the DSI because (1) it gives buy and sell signals only rarely, (2) it has a very limited technical following, (3) it has an impressive record of being right when properly interpreted. The accompanying chart traces the DSI back to 1931. Sell signals are provided when the DSI drops below the critical 1.0 level, buy areas are identified when the DSI climbs above 1.5 or preferably 2.0.

I have marked the sell areas (DSI under 1.0) in solid black. The first such area occurred in 1933, when the DSI held below 1.0 for seven consecutive months. This was followed by the panic of 1933. A second sell signal was seen during 1939. The DSI registered .56 and .82 during September and October, 1939, and this was followed by a long "line" in the Averages, and a panic in May, 1940 (as France fell to the Nazis).

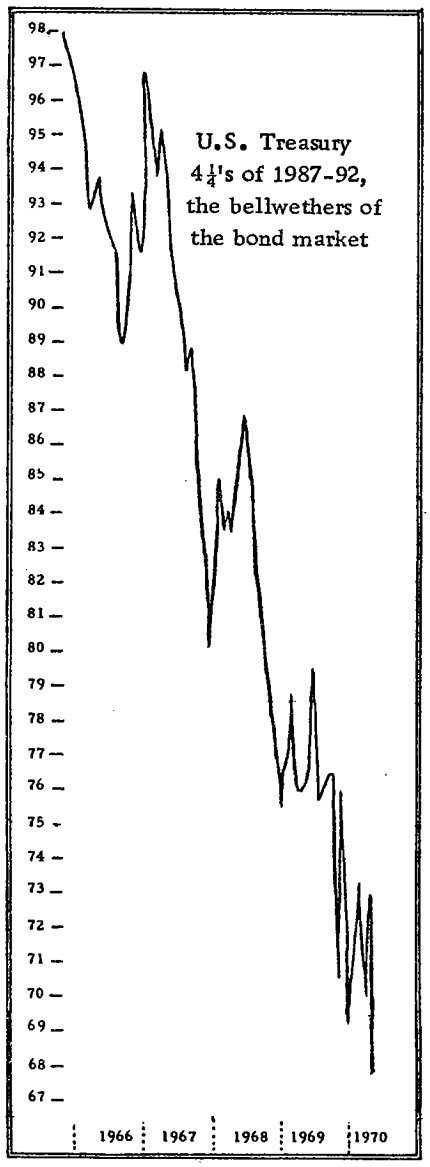
An important sell signal materialized in 1946. The DSI dropped below 1.0 and held there during February, March, May and June, 1946, prior to the drastic crash of August, 1946, and its accompanying three-year bear market.

The year 1961 saw the development of another major sell zone, the biggest up to that date. The DSI sank below 1.0 in January, 1961, and it held below 1.0 for 13 consecutive months — until January, 1962. This ominous performance was followed by the drastic 1962 collapse, a break which took the Dow from 734 to 535.

During January, 1968, the DSI again dropped under the critical 1.0 level. What followed was the most bearish performance in the history of the DSI. In the 28 months since January, 1968, the DSI has held under 1.0 in all but two months. Thus, we now have the longest black (bearish) area on the chart in its 39-year history. The current bear zone has lasted better than twice as long as 1961-62, a period characterized by a 199-point drop in the Dow. To aid in this study, I have included an enlarged section of the DSI (covering the years 1962 to present) in the upper left corner of the long-term chart.

It is of interest that no major advance has ever started while the DSI was below 1.0. In fact, every important advance on the chart has developed from an area in which the DSI was registering 2.0 or better. The message from the DSI is clear at present. It is saying that we are continuing in an extremely dangerous zone, and that no major advance will start at this time (April figure for DSI, .87).

BONDS: Ever since the much-heralded reduction in the prime rate to 8% a few months ago, hopes have been rising for the "coming big rally in the bond market." I kept reminding subscribers that there probably wasn't going to be any big bond rally. At least, if there was it wasn't showing on any of the charts or data which I keep. The reasons for the absence of a rally is the absence of any control over spending and inflation, and the advent of a liquidity crisis. This year's game (as has been the case in almost every year since World War II) has again resolved itself into betting on how big the Federal deficit is going to be. I have heard forecasts on the deficit ranging from $4 billion to $15 billion. My own guess, much bigger than $15 billion, and this because of a collapse in corporate profits.



But to get back to bonds, I include my chart of the Treasury 4¼ of 1987-92, considered to be the bellwether of the bond market. This bond touched an extreme low bid of 67 7/8ths in December, 1969. Following that low, the 4¼'s rallied twice into the 73 area. In Letter 451 and again in Letter 456 I warned that the 4¼'s were sinking and that "talk" of the big bond rally simply did not jibe with the facts. On May 4 the 4¼ bellwether plunged to 67 3/4 bid, an historic low at which level this bond yields 7.10%.

The latest collapse in bonds is being blamed on the Cambodian mess, but in my opinion bonds were heading to new lows anyway. Cambodia is just one more visible sign in a long string of blunders and mis-judgments (financial and political) which have characterized the U.S. scene for the past decade. Actually, I believe that bonds are reflecting the near-liquidity crisis which is now enveloping the U.S. With corporations gasping for cash, with record mountains of new bonds lined up to come to market, with many important corporations on shaky financial grounds, the bond market is simply sitting at a level at which it is discounting major potential trouble.

Smith, Barney & Co. in a lengthy report (end of March) stated that there is a $214 billion difference between current corporate assets and liabilities, and it will require roughly $25 to 35 billion in new money to prevent further liquidity deterioration. My question is, with the bond markets in shambles how in the devil is this nation going to absorb anything like $24 to 35 billion in new long-term offerings? Indeed, the situation is so scary that it dwarfs in import anything else on the financial scene. In my opinion, the bond market must find bottom before the stock market even starts looking for a bottom. The crux of the crisis is debt, and the symptom is liquidation and rocketing interest rates.

The bond performance is the more ominous in that it has materialized in the face of a collapse in the stock market. Normally, when stocks go down much of the money that leaves the stock market moves into bonds and bonds then rally. That has not been the case over the past few years.

Last week the editor of the Weekly Bond Buyer (which has been taking a hopeful stance on bonds) all but threw in the sponge. He wrote: "The open question remains whether or not we are witnessing the beginning of a classic run, one which can nevertheless be averted, into a money panic, resulting from the headlong demand for capital burning up investment funds faster than they can be generated, and developing simultaneously with collapse of speculative positions..... Rumors on the Street are plentiful, specific and ugly, involving capital shortages on the Street and abroad, and possible overseas liquidations on a

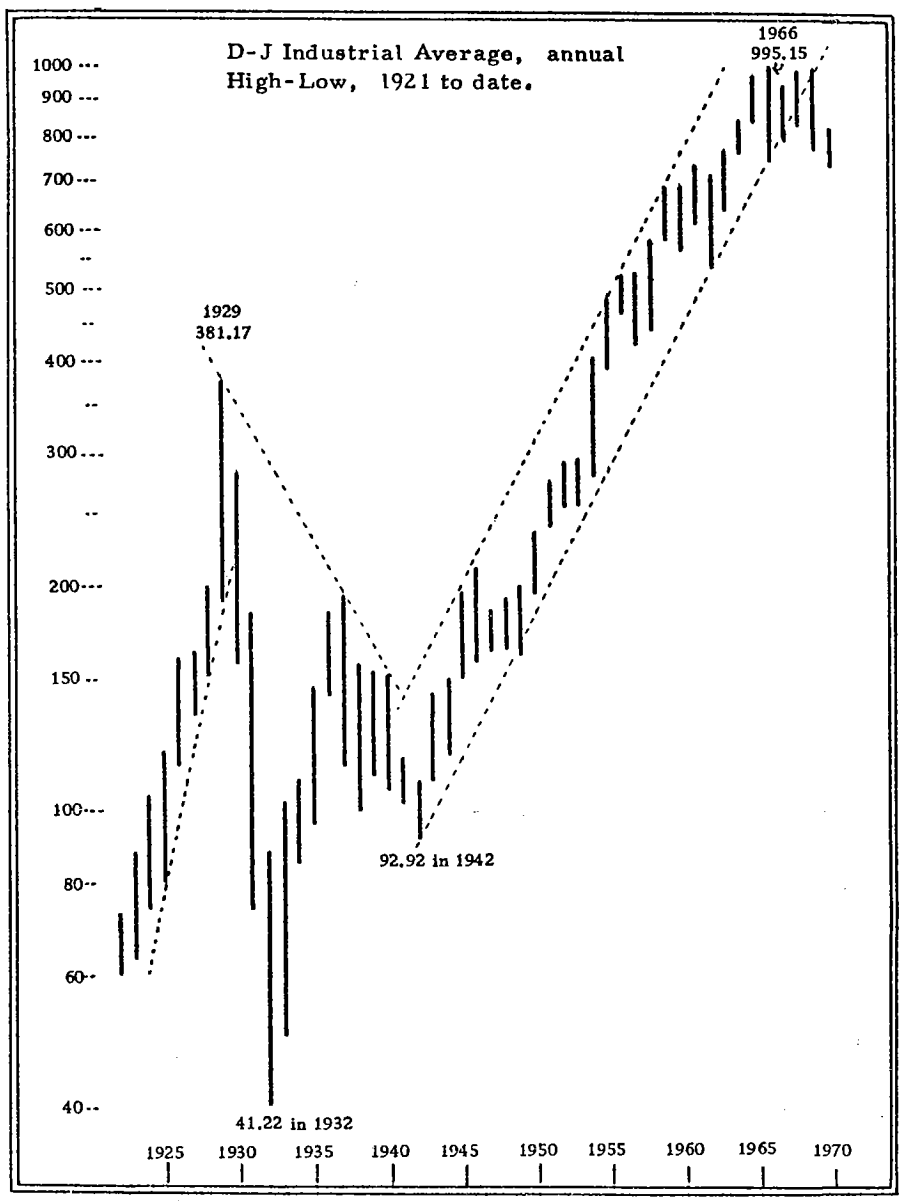
large scale. There are also reports of margin calls, both against positions and against six figure loans made to corporation executives on options some while ago."

One man who comprehends the seriousness of the bond-debt fiasco is outspoken economist Eliot Janeway. In a recent report Janeway warned, "The source of the trouble in the stock market is the trouble in the bond market. The bond market is the second of the three analytical urgencies — the trend of the economy is the third. Of the three, the bond market, rather than the stock market or the economy as a whole, represents the submerged portion of the iceberg.....During these past three years of die-hard optimism on the part of the speculating public, the bond market has been suffering its own private replay of 1929. The advisors in vogue have been in general agreement that the bond market has been a victim of inflation. My dissent has amended this to read that the bond market was merely the first victim of the inflation; and that the stock market would be the second."

All of which I agree with. But Mr. Janeway and I disagree on the next premise. In my opinion, the economy is going to be the "third victim".

PERSPECTIVE: Here is a chart of the annual high-low range of the D-J Industrials, drawn to semi-logarithmic or ratio scale. Ever since 1966 I have been drawing attention to this chart, and the thesis that a bear market would ultimately reverse the long-upward channel which carries from 1942 to 1966.

During 1967 the Dow slid slightly below the lower channel line, and during 1968 the same thing happened again. The year 1969 saw the Dow drop decisively below the channel for the first time. And now in 1970 we see the first year in which the Dow range (so far) has not come anywhere near the lower line of the channel. Clearly, the great upward thrust of the 1940's, '50's and '60's has now been reversed.



It is also important to note that the years 1968, 1969 and 1970 saw successive new lows for the Dow, the low for 1968 being 825.13, the 1969 low being 801.96 and the current low for 1970 being 709.74. A series of three successive annual lows has not occurred since 1940, 1941 and 1942. At that time the world was about to plunge into a holocaust, and during 1942 the question of whether the Allies would win or lose the war was a real one.

Personally, I believe that the current series of three successive annual lows is a very ominous formation, and I urge subscribers to prepare for what may be shocking news in the months ahead. My studies suggest that the market is in the process of discounting many frightening and tragic events, events which may seem well nigh incredible to those of us who are now emotionally prepared.

RIPS IN THE FABRIC: I read the daily papers each morning, and the uneasy question keeps emerging, "Is America slowly and relentlessly slipping into anarchy?" President Nixon's latest gamble, the march into Cambodia, may be the straw that broke the nation's collective backs. The Senate is in a rage, universities across the land are closing down as the students

(and the teachers) take to the streets, the market is tumbling, even the great, "silent majority" is beginning to wonder what it's all about. What happens, I say to myself, when the stock market smashes and the very structure of middle-class, solid America comes tottering down? Will the men in the sport shirts and flannel suits join with the students? Will the disillusionment be too much for the silent ones? Time will tell, but I don't like it. I know what happens to people who have lived a lie all their life, when they finally wake up to find that the lie is themselves.

They don't want to face that. They want to blame someone else. The guy who is over his head in debt, in a house too big for his pocketbook, with a pool and two cars he does not need, will not easily face the fact that the idiocy is his own. He's much more likely to turn on "them". Them is the.....but why go into that. We'll find who them is when the time is right. Perhaps "them" wrote some of the little quotes I list on this page.

SMILE: It strikes me that a bit of humor would not be amiss at this time. The clip below draws attention to my new "Asperin Indicator," which apparently hits record peaks during market collapses of more than 200 points on the Dow.

Aspirin Output At Record High

Special to The San Diego Union

NEW YORK — U.S. production and sales of aspirin during 1969 totaled more than 37.5 million pounds, a 21 per cent increase over 1968, the Food & Drug Administration estimates.

Only once before has aspirin production ever approached that level — in 1966 when 34 million pounds were produced.

AS TIME GOES BY: "There are some definitely encouraging elements. The ratio of casualties between Government and Viet Cong forces, the ratio of arms captured, ... the steady extension of the strategic-hamlet program, ...all those indicate some turning in the situation."—Dean Rusk, February 1, 1963.

"The momentum of the Communist drive has been stopped." —Dean Rusk, February 13, 1963.

"There is a good basis for encouragement. The Vietnamese are on their way to success and needed our help." — Dean Rusk, April 22, 1963.

"Secretary McNamara and General Taylor reported their judgment that the major part of the US military task can be completed by the end of 1965, although there may be a continuing requirement for a limited number of US training personnel." — White House statement, October 2, 1963.

"We believe that the present (Saigon) regime has moved promptly to consolidated public effort, and that the people of that country will move in greater unity on behalf of the total effort." — Dean Rusk, November 8, 1963.

"I think that resources and capabilities are there to get this job done on the present basis of assistance to the Vietnamese so that they themselves can handle this problem primarily with their own effort." Dean Rusk, February 24, 1964.

"I think they (the Viet Cong) have very serious problems— not only in fact, in terms of losses, disruptions, but in terms of morale. So I am not pessimistic about the situation." — Dean Rusk, July 1, 1964.

"I am hopeful we can bring back additional numbers of men. I say this because I personally believe this is a war the Vietnamese must fight....I don't believe we can take on that combat task for them." Robert McNamara, February 3, 1964.

"I think on balance the number (US training personnel needed in Vietnam) is not likely to increase substantially." — Robert McNamara, May 14, 1964.

"The most vital impression I'm bringing back (from Vietnam) is that we've stopped losing the war." Robert McNamara, November 30, 1965.

"We are beginning to see some signs of success of this strategy..... The number of defections this year has doubled compared to the past year. No doubt this is a sign of erosion of morale."—Dean Rusk, August 25, 1966.

"I so believe that one basis for optimism is that the other side must surely now understand that they are not going to succeed in seizing South Vietnam by force." — Dean Rusk, January 1, 1967.

"I think we have seen some very favorable signs that we are making headway on the military side.... I must say that I have been impressed by the doubling of the rate of defectors from the other side." Dean Rusk, April 16, 1967.

"During the past year tremendous progress has been made..... The enemy has not won a single, significant victory during the past year, despite the tremendous effort that he has put forth." — General Westmoreland, July 13, 1967.

"Suffice it for me to say that we are generally pleased with the progress we have made militarily. We are very sure that we are on the right track." — President Johnson, July 13, 1967.

"The other side is hurting, and they are hurting very badly." — Dean Rusk, July 19, 1967.

"This (Tet) offensive has required us to react and modify our plans in order to take advantage of the opportunity to inflict heavy damages upon the enemy. Although the enemy has achieved some temporary psychological advantage, he suffered a military defeat." — Gen. Westmoreland, February 25, 1968.

"There is a long road ahead. There will be blood, sweat and tears shed. The weak will drop from the lines, their feet sore and their voices loud." — President Johnson, February 27, 1968.

"Let me be quite blunt. Our fighting men are not going to be worn down. Our negotiations are not going to be talked down. Our allies are not going to be let down." From President Nixon's May 14, 1969 speech to the American people.

"This is not an invasion of Cambodia....Once enemy forces are driven out of these sanctuaries and their military supplies destroyed, we will withdraw...A majority of the American people want to end this war rather than have it drag on interminably. The action I take tonight will serve that purpose." From Pres. Nixon's speech to the nation, April 30, 1970.